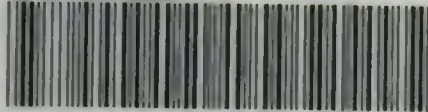


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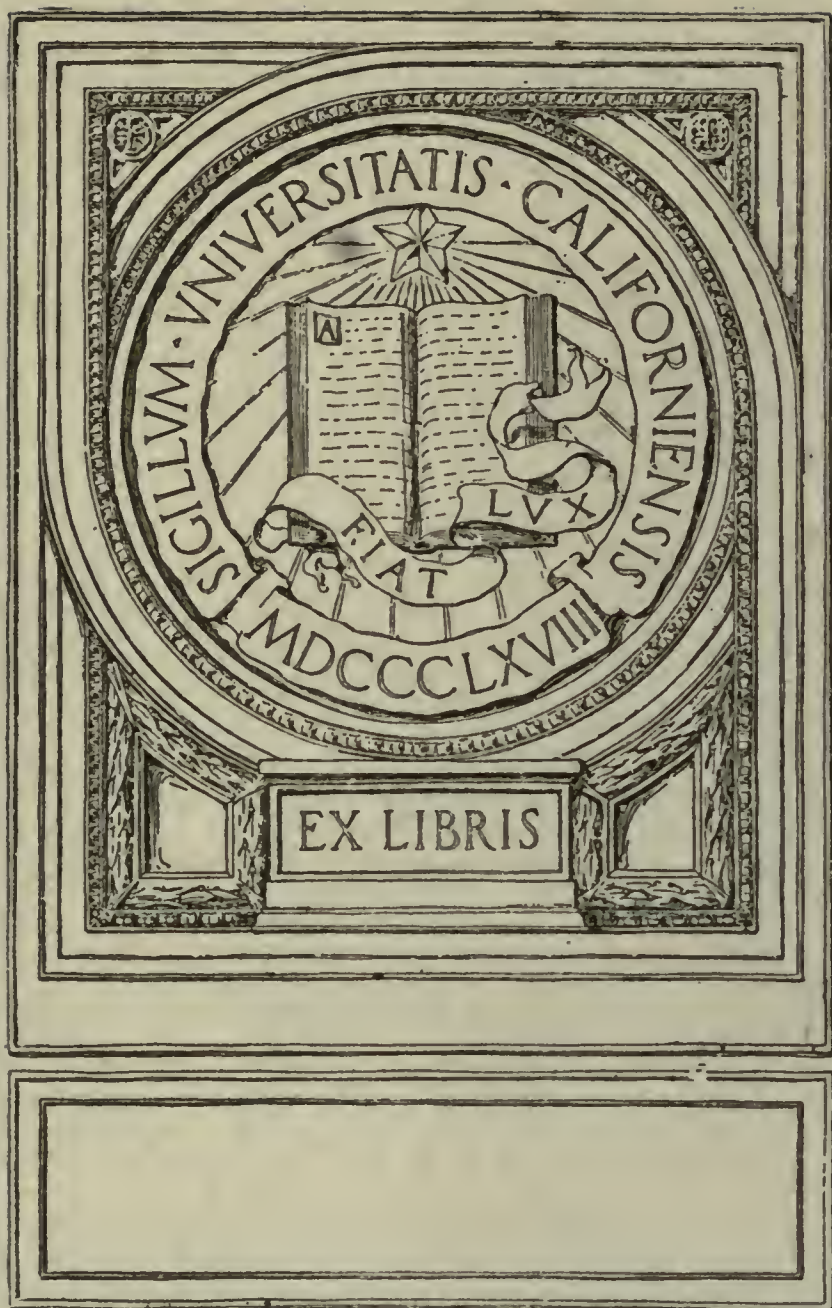
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Liability and Workmen's  
Compensation Insurance  
ON THE  
Reciprocal or Inter-Insurance Plan

By  
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CALIFORNIA

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## LIABILITY AND WORKMEN'S COMPENSATION INSURANCE ON THE RECIPROCAL OR INTER-INSURANCE PLAN

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In an address delivered before the Annual Convention of Insurance Commissioners, September 23rd, 1915, Hon. John S. Patterson, the Commissioner of Insurance and Banking of the State of Texas, said:

"During 1914 the people of Texas were swindled out of not less than one million of dollars by so-called inter-insurance, to say nothing of the unpaid losses. There were forty-nine holding certificates from the Department when I came into office on January 23rd of this year; to-day there is not a certificate in force. Out of the above number there were some transacting an honest insurance business; others knew no limit to their rascality. Texas can point with pride to its cemetery of dead reciprocals, to say nothing of those in the hands of the undertaker; but neither my State nor yours can point with pride to any law that will bring these swindlers to justice. Those that are now languishing in our jails are there by indictment of a Federal grand jury for the use of the mails to defraud."

A somewhat similar stand against reciprocals and inter-insurers has been taken very recently also by the Insurance Commissioner of Ohio.

How reciprocal insurance may and sometimes does operate to defraud is illustrated in the Bulletin of the West Virginia Insurance Department, February, 1914. A firm in Parkersburg, W. Va., having suffered a loss of about \$30,000, insured under a policy of a reciprocal indemnity exchange, sought to sue because payment of its claim was refused. They then found that the exchange itself was not liable, but that they were in fact insured piece-meal by the other subscribers to the exchange, of whom there were several hundred scattered over many States, each one of whom was liable for only about \$70 or \$80. The exchange refused to disclose the names and addresses of these subscribers; and in any event it would probably have cost about as much as the amount involved to collect such a multitude of small claims and to carry on the litigation incidentally necessary. Consequently the policy was almost worthless. In this instance a relatively low premium rate and pleasing dividends made the insurance eminently satisfactory to the policyholder until a substantial loss occurred; then the cat was out of the bag and the policyholder discovered that the reason why his supposed insurance was so pleasingly cheap was that it was not true insurance at all.

According to public reports a somewhat similar experience has been encountered by the Forest Mills Timber Company, of Comiplex, British Columbia, with a policy in a foreign reciprocal exchange. The Forest Mills Company having suffered a fire loss of over a



hundred thousand dollars and the exchange having refused payment, the Company sued one of its co-subscribers, another lumber company in British Columbia, for the latter's share of the liability, and was met with the following defences: (1) That the exchange had no right to do business in British Columbia. (2) That it was *ultra vires* for the plaintiff to enter into a contract of inter-insurance. (3) That it was *ultra vires* for the defendant to enter into such a contract. Whether or not these defences are valid under the law of British Columbia is uncertain. But it is certain that what the Forest Mills Company bought when it paid for its policy was not true insurance, but only a gambling chance in litigation on questions of law, and that its prospects of ever collecting the face value of that policy, or anything near it, over and above expenses, are very dubious, regardless of the merits of its claim to indemnity.

A further experience in the same line was reported by Mr. Arthur Hawxhurst, insurance manager for Marshall Field & Co., in an address before the Insurance Society of New York, April, 1916, in which address Mr. Hawxhurst characterized the usual reciprocal contract as a "great soft snap" for the manager of the exchange, scored liability insurance on the reciprocal plan, and warned business men to stick every one to his own trade and not to venture on the side into the little-understood and dangerous field of reciprocal insurance.

Reciprocal or inter-insurance (both terms meaning the same thing) is not necessarily so bad. Why then is it that this form of insurance so frequently leaves the policyholder in the lurch? The answer is that, whereas fraudulent and unsound practices are generally prevented in other forms of insurance by salutary public regulations, the promoters of reciprocal insurance have succeeded in many States in obtaining exemption from the greater part of the regulations common to other insurance—indeed in some fifteen States they have obtained special legislation, known as the "standard reciprocal law," which not only exempts them from all effective regulation and supervision but also positively protects them in unfair and fraudulent practices. In this paper it will be shown how that law permits the promoters of so-called reciprocal insurance, if they be unscrupulous, to impose upon their customers.

#### WHAT IS RECIPROCAL INSURANCE?

Reciprocal or inter-insurance is a hybrid between Lloyds insurance and mutual insurance, in which the stronger features of each of these older forms of insurance are eliminated. In reciprocal insurance the members or subscribers, through an attorney-in-fact, mutually contract to indemnify one another against loss, each member binding himself as an insurer severally and not jointly, and each member limiting his liability either to some fixed proportion of each single loss, or in the aggregate to some fixed proportion of his annual premium, or sometimes both ways. Such insurance is usually promoted by a person—sometimes a corporation—operating an "exchange," who secures from the subscribers powers-of-attorney constituting him their attorney-in-fact, with broad powers to enter into indemnity contracts for them and to manage the business, but without



personal responsibility on his part for the payment of the indemnities or for anything else of importance. In remuneration for his services the attorney-in-fact usually contracts with the subscribers that he may deduct some large percentage from their premiums. Consequently the primary interest of the attorney is to secure promptly a large volume of premiums. If his interest for immediate profit should conflict with methods and practices requisite to secure the ultimate success of the insurance scheme and to do justice to and among his subscribers, he is under every temptation to sacrifice the latter. In other words the subscribers assume all the risks but confide the entire management, subject to no check or control, to a stranger with primarily antagonistic interests.

It is sometimes claimed that a reciprocal exchange operates on practically the same basis as "Lloyds insurance." In form there is some resemblance between them, but in substance they are radically different. Every one of the existing, reputable Lloyds exchanges is an association of well known and wealthy firms and individuals, doing business at one place, which, through its various members, each acting individually for himself and as agent for the others, sells insurance to the public, each member of the association assuming some fixed part or proportion of the risk on each policy. Such associations differ from reciprocal exchanges in that they are managed by the members and not by an irresponsible third party, in that their members are experienced insurers by profession and are engaged for profit in the business of insuring third parties instead of one another, and in that the members are known to the policyholders and are highly responsible and readily accessible in the event that suits on a policy become necessary. Moreover it is generally recognized that a "Lloyds" policy is not suitable for workmen's compensation, with its chances of liabilities running for years or even for a generation. To cover such long continuing liabilities something more stable than a short-lived association is desirable. For such liabilities only an incorporated insurance carrier can fill the bill. Indeed, after having enjoyed a craze, "Lloyds" is not now regarded as a desirable method of insurance, save in some few lines, and then only under exceptional conditions, which conditions are now in fact fulfilled by only a few surviving groups of insurers doing business each in some great financial or commercial center.

#### RECIPROCAL POLICIES AND POWERS OF ATTORNEY

Having now seen in a general way what reciprocal insurance is and is not, let us take up the so-called standard reciprocal law, and see how it opens the door to frauds and impositions upon the public.

In the first place, as to the policy and power-of-attorney: Whoever draws a contract naturally draws it to favor himself, with little regard to the interests of the other party; and where the party drawing the contract is an expert in the subject matter and the other party is comparatively ignorant, very "raw deals" frequently result. Insurance being a peculiarly technical subject, experience has shown that the public is peculiarly liable to be imposed upon by insurance contracts. Therefore, generally, the laws relating to fire and com-



pensation insurance provide that every policy and all important incidental papers constituting the contract shall be in some standard and approved form, from which all unfair and "trick" clauses have been carefully excluded by the public authorities. And this form of regulation is steadily spreading. Honest insurers favor rather than object to it. But under the reciprocal law, the policies and powers-of-attorney used in the operations of a reciprocal exchange are exempted from any such regulation, and the attorney-in-fact is allowed to draw them to suit his own interests and in a form to mislead his customers. It is true that the reciprocal law requires the attorney-in-fact to file copies of his forms of policies and powers-of-attorney with the Insurance Commissioner; but it does not require the approval of such forms by such Commissioner. No matter how unfair and misleading the Commissioner may perceive their terms to be he must meekly accept and file them, and let the swindle proceed. In other words, this requirement of the statute is worse than no regulation at all, for it is a sham and a deception.

#### THE RECIPROCAL EXCHANGE

In order to operate under other insurance laws, generally, there must be a corporation or something like it, with responsible and bonded officers, with funds in certain specified forms, deposited in certain places, controlled by certain public authorities, etc.; in short there must be some tangible, stable, responsible and publicly regulated organization obligated to pay the loss on its policies.

Under the reciprocal law, however, all that is required of the attorney-in-fact, in order to secure a certificate entitling him to do business, is that he shall file an affidavit stating the location of his "exchange," that he has a certain number of subscribers applying for policies covering risks aggregating a certain amount, that he has on deposit at least \$25,000 available for the payment of losses, and a few other unimportant particulars. He need give no security and need not deposit his money anywhere in particular—indeed he need not even say where it is,—he need not specify his subscribers, and he is expressly relieved from any obligation to furnish their names and addresses. Consequently, the only substantial obligation as to him is that he shall fix upon some definite place for his exchange. As to his subscribers, he is required to make the Insurance Commisisoner their agent for the acceptance of legal process; but, because he need not furnish the names and addresses of any of such subscribers and because judgment upon such service would be ineffective against persons unknown and unnamed and invalid against subscribers residing outside the State, this requirement is almost worthless to creditors of the exchange.

Thus by this statute an irresponsible exchange—a mere place, where no funds need be kept—is substituted for a responsible corporation, and special obstacles are created in order to prevent the responsible subscribers from being reached.

It is true that the attorney-in-fact may appoint a responsible treasurer or board of advisers. But the law does not so require. Though the usual power-of-attorney provides that an advisory board or committee shall be appointed, it gives the attorney, either expressly



or by indirection, either the right to select the members or the means to eliminate objectionable members, and confers upon the members no power to supervise or to interfere with the management and no responsibility therefor. Such provisions are most blatant devices to deceive subscribers and to withdraw their attention from the fact that the standard reciprocal law secures them not even the right to look into the operations of their exchanges.

#### CONTINUED SECURITY

Once authorized to commence business, a company operating under other insurance laws generally is required by such laws to maintain its organization, its capital, its deposits, etc., unimpaired, besides building up reserves to cover its accumulating liabilities; and the Insurance Commissioner is given the authority and the means to see that it does so. If at any time it is in default in any of these respects or the Insurance Commissioner has good reason to believe that its solvency is seriously impaired, generally, he may dissolve it or revoke its certificate.

Not so with reciprocal exchanges in those States wherein the standard reciprocal law is in force. That law exempts such exchanges from all practical requirements as to reserves and from all effective supervision, its provisions which seem to provide for a reserve and for supervision being cunningly devised shams.

Nominally the reciprocal law provides that the Insurance Commissioner may revoke or suspend the certificate of an exchange "in case of breach of any of the conditions imposed by this act." But the only conditions imposed by the act amount to nothing. They are as follows:

FIRST. "There must be maintained at all times as a reserve a sum in cash or convertible securities" equal to 50% of the balance of premiums or deposits collected for the current year after deducting the attorney's commissions, at no time less than \$25,000. But where must such reserve be maintained? The answer is that it may be maintained anywhere—in a distant State, spread around among or kept moving between many banks in distant States, in the attorney's pocket, or anywhere else he may select to hide it from his subscribers and creditors. Indeed there is nothing in the law practically to prevent his using the same sum of money or bunch of securities as the reserve for each of a whole chain of exchanges. It is manifest that this provision is not conducive to security, but rather to the contrary.

SECOND. The attorney-in-fact must make an annual report to the Insurance Commissioner showing that the financial condition of affairs at his exchange is "in accordance with the standard of solvency provided for herein," and stating the premiums or deposits collected, the losses paid, the amounts returned to subscribers and the amounts retained for expenses. There are two palpable jokers in this provision which mark it as a sham. In the first place there is no standard of solvency provided for in the law. In the second place the items to be reported do not include the one most necessary item that should be reported to determine solvency, namely the amount of



outstanding liabilities. Under this system of fake reporting an exchange may be all the time piling up a deficit at a startling rate, and yet every year be able to file a nominally true report indicating to the contrary that it is solvent. The law then goes on and gives to the Insurance Commissioner authority to investigate directly into the business affairs and assets of the exchange, "as shown at the office of the attorney thereof." That looks like full power of supervision. But in reality it is not. If the Commissioner cannot find out anything at such office, he is at the end of his certain authority. And, on the other hand, if he does find out something at such office, no matter how bad it may be, no matter how insolvent it may disclose the exchange to be and no matter how crooked it may show the exchange's practices to be, he may not be able to do anything effective about it. He cannot wind up the exchange. He cannot revoke its certificate; but on the contrary it can continue to trade on the certificate, using such certificate to deceive the public into believing that it has the approval of the Commissioner. And he may not be able even to warn the subscribers; for the attorney cannot be made to furnish him the names and addresses of any subscribers.

In this connection it should be noted that the crusade in Texas against reciprocal swindlers, described in the opening quotation in this paper, was under a different form of law, which contained a provision empowering the Insurance Commissioner to revoke the certificate of a reciprocal exchange for "reasonable cause." And similar provisions in the Ohio law enabled the Commissioner of that State to act to stop abuses. In contrast the standard reciprocal law contains no provision of the kind, but on the contrary is so drawn as to prevent the Insurance Commissioner from interfering with dishonest practices. It is in effect an express license to swindle.

THIRD. Whenever demanded the attorney-in-fact must report under oath to the Insurance Commissioner that he has made certain inquiries into the commercial rating of his subscribers and that from such inquiries "it appears that no subscriber has assumed on any single risk an amount greater than 10% of the net worth of such subscriber." This provision is pure humbug. It is a parody on the provision usual in insurance laws which forbids a stock company to carry, without reinsurance, any single risk in excess of 10% of its paid up capital. It does not prevent a policy being written on a single risk out of all proper proportion to the exchange's resources; for it permits an exchange with only \$25,000 available for the payment of losses, to issue a policy for \$2,000,000 on a single risk, if it have 400 subscribers no one of whom "appears" to the attorney-in-fact to be worth less than \$50,000. It does not protect the insured by limiting the amount of his policy to an amount which he can possibly recover; for the powers-of-attorney under which the exchange's policies are executed may, for example, provide that the liability of any one subscriber shall be limited to the amount of his annual premium, and the aggregate of such annual premiums of all the subscribers may be much less than the amount for which a policy may be written under this provision. Nor does it protect the individual subscriber by limiting the amount for which he may be made



liable as an insurer on any single risk to 10% of his worth; for it merely prescribes what the attorney-in-fact must do as a condition to his right to continue business, and does not purport in any way to affect or limit the liabilities of subscribers, which liabilities must be limited, if at all, by the terms of their contracts.

#### THE SUBSCRIBER'S CONTRACT

Now, having seen what the usual reciprocal law provides, it remains to analyze the usual contract under such law. Generally that contract is contained in a power-of-attorney and a policy of insurance.

The power-of-attorney, which is executed by the subscriber and delivered to the attorney-in-fact, empowers the attorney to bind the subscriber to a large number of contracts, whereunder the subscriber agrees to indemnify his associates against loss, and to do many other things incidental to the business of insurance as the agent of the subscriber.

Usually or, at least, commonly it contains also provisions to the following effect:

1. That the attorney may deduct some fixed percentage of the subscriber's gross premiums for the former's services and expenses.

2. That the attorney may deduct some further percentage of the subscriber's gross premiums to pay for inspection of risks, adjustment of losses, etc.

3. That the attorney shall select and appoint some reasonable number of subscribers as an advisory committee and may deduct reasonable fees and expenses for them out of the premiums.

4. That the liability of the subscriber on any one contract, or on all contracts, executed for him by the attorney, shall be limited to the amount of his annual premium or deposit, or to some other definite sum.

5. That the subscriber shall be liable severally and alone for his share of any loss he insures, and not jointly with the other subscribers; and that the subscribers shall have no joint funds and no power to act for or to bind one another.

6. That, except as above, the attorney shall have no ownership or property interest in the premium or deposit funds; and that the subscribers shall have no ownership or property interest in the business, office or office property of the attorney or of his exchange.

7. That either party may revoke the power-of-attorney and the policy upon some specified number of days' written notice; and that upon the expiration of such time the subscriber's equitable *pro rata* part in the premium and deposit funds shall be determined by the attorney and returned to the subscriber.

The policy, on the other hand, is executed by the attorney and delivered to the subscriber. Usually it binds the other subscribers to the exchange each, severally, to indemnify the policyholder for some part or proportion of any loss he may suffer, not exceeding, however, the amount of one annual premium, and the aggregate being, of course, limited to the amount specified in the policy. It also usually provides that on any claim under said policy a test suit



must first be brought against some one of such other subscribers and be determined, before any more or all of them may be sued.

Taking this contract as a whole it is remarkable for its one-sidedness. It secures to the attorney a high and certain remuneration and extensive powers, but imposes upon him no corresponding risks, duties or obligations. He takes the subscribers' money without mention of bond or security. He does not undertake to keep the funds with any responsible depository. He does not contract to keep books of account or accessible lists of his subscribers. He does not undertake to follow any definite policy or to conform to any definite standards in his operations. And he most distinctly does not assume to continue his exchange after it ceases to be profitable to him personally, nor any responsibility for the solvency or ultimate success of his insurance. On the contrary he secures an untrammelled right to use his agency and his subscribers' money as may best further his own interests, regardless of their interests. It is true that the contract often provides for an advisory committee; but it provides, either expressly or in effect, that the members of such committee shall be selected by the attorney, instead of being duly elected by the subscribers, and shall be dependent upon his discretion for their remuneration; and it is carefully drawn so as not to give even that "hand-picked" committee any right to supervise or control the operations of the exchange.

Obviously this is fine for the attorney. But what do the subscribers get back in return for their blind trust? That, of course, will depend upon the personality of the attorney, since he may do what he pleases with his subscribers' money. If he is honest and expert, collects premiums high enough not only to pay losses due but also to maintain reserves sufficient to cover all outstanding liabilities, liquidated and unliquidated, due and deferred, and keeps his funds, books, etc., so that they will be accessible to policyholders in the event of his death or otherwise, the subscribers may get what they expect. But if, on the other hand, in order to keep his premium rates down low and thereby to increase his subscriptions and consequently his commissions, he permits the deferred liabilities to accumulate until he can no longer meet them without raising his premiums to rates his subscribers will not stand, what then? The attorney has nothing to fear from such a contingency. He can calmly shut up shop and quit, content with his past profits, for he has no responsibility for any tangle in which he may involve his subscribers. What then would be the mutual rights and liabilities of the subscribers?

Of course the answer to that question will depend upon the terms of the contract; and the general form of contract hereinabove set forth is only one of an infinite number of possible forms that the attorney-in-fact may devise. Actually many different forms are in vogue. And they are frequently changing; because it is easy, as soon as the tricks in one form become apparent to the public, to resort to some other form. But it will be sufficient for illustration to study the results under the form at present apparently prevailing, which most strictly limits the subscriber's liability as an insurer, if the reader will realize that howsoever that form may be varied from



there will be no gain for the subscribers collectively, though it may greatly alter their individual rights and risks, so long as the attorney-in-fact reserves to himself the uncontrolled management of operations and large commissions upon gross premiums, without assuming any material risks or obligations, and that it is easy for an expert attorney to draw a contract so that it will seem to laymen to provide everything imaginable for the protection of subscribers and yet effectually do nothing of the kind.

In this connection it should always be borne in mind that each subscriber is not only an insured but also an insurer. On the one hand, each of his co-subscribers may owe him something as indemnity for his losses; but, on the other hand, he may owe each of them something on account of their respective losses. Consequently when he has recourse against them for indemnity, many of them, in turn, may have valid claims against him for indemnity. How, in such a mix-up, can he recover the indemnity due him? And how about what he in turn owes them? But before taking up that problem, it is desirable to notice how it is affected by the special features of workmen's compensation.

#### WORKMEN'S COMPENSATION

Under the workmen's accident compensation laws an employer may become liable to his workmen and their dependents for weekly payments continuing during many years or, in some States, for life. Under nearly all those laws, the employer is not discharged because he has insured his liability; but his insurance carrier becomes bound either to make such payments for him, leaving him still obligated if it fails to do so, or to indemnify him for such payments when and as he makes them. Consequently when an insured employer suffers a loss whereby he becomes liable contingently for some thousands of dollars in compensation, his insurance carrier does not become obligated to pay the capitalized value of such liability at once, but only to indemnify him as to each payment when it falls due. This makes the employer interested not only in the immediate solvency of his insurance carrier, but also and equally in its continuing ability to indemnify him up to the date when the last payment on his insured liabilities may fall due. Where many employers, each continually suffering compensation losses with deferred liabilities, are insured in a reciprocal association, it should be obvious that, if the current premiums cover merely the payments on liabilities falling due within the current period, leaving the deferred payments upon accrued liabilities to be provided for in the future, there will necessarily be a mass of deferred liabilities progressively accumulating for many years, for which the subscribers will eventually become liable one to another in varying amounts. In that event any subscriber who thinks that his liabilities to his workmen are covered by his insurance will find instead that his rights as an insured are approximately offset by his liabilities as an insurer. To illustrate: Suppose that A, B and C associate for reciprocal insurance, paying into the treasury of the association each year premiums sufficient only to cover the payments of compensation to their injured workmen falling due within that year: At the end of ten years it may be that A will be liable for



compensation payments to become due in the future for past accidents to his employees aggregating \$20,000, that B will be similarly liable for \$17,000 and that C will be similarly liable for \$15,000. Suppose that they then dissolve their association;—C will be entitled to no indemnity from A or B, but will have to suffer his loss of \$15,000 unindemnified, besides which he will owe something to A and B. And A and B will each have an unindemnified loss of \$17,000 or over to suffer. Obviously that is not insurance, but merely a partnership in losses. And the same would be true no matter how much larger might be the membership of the association. There can be no assurance of the amount due on a policy unless a responsible third party, without offsets, is liable therefor, or unless, in reciprocal insurance, there are reserves covering the accrued liabilities. The gross defect of reciprocal insurance of workmen's compensation is that neither the reciprocal law, nor the usual contracts made under that law, provide for the maintenance of such reserves. Such exemption from the obligation to maintain adequate reserves, in conjunction with the fact that liabilities for compensation are so extremely long deferred, gives the unscrupulous attorney of a reciprocal exchange an exceptionally long time to make his money and get out, leaving his insured subscribers and their workmen to "hold the bag." Our American compensation laws have not yet been in effect long enough to illustrate the extraordinary danger to the insured from speculative methods in this line of insurance; but foreign experience has amply demonstrated it. For this reason, it is publicly reported, the Insurance Commissioner of Massachusetts has condemned workmen's compensation insurance in reciprocal or inter-insurance associations.

We can now take up the crucial question: Under the contract above set forth, the attorney-in-fact assuming no responsibility to see that the losses insured by the policies he issues will ever be paid or even to assist the insured in securing their payment, what are the rights and liabilities of the policyholders among themselves if and when the attorney-in-fact closes up his exchange, defaults, or otherwise throws them upon their own resources? And what is the position of an injured workman whose compensation is insured by such a policy, if his employer is then insolvent?

#### THE REMEDY ON A RECIPROCAL POLICY

Where the holder of a reciprocal policy suffers a loss he is accustomed to look to the attorney-in-fact for his indemnity. The latter may pay it or he may not. If the loss be for workmen's compensation the attorney may indemnify the insured for his compensation payments for some time and then quit. If, then, a time comes when the attorney does not pay an indemnity due, or having indemnified an insured for some of his compensation payments quits before completion, what is the latter's remedy, assuming the contract to be as hereinbefore stated? He has no effective remedy against the exchange; for it is merely a place and not a person or a corporation. He cannot successfully sue the attorney-in-fact; because the latter has hedged himself against all personal liability. Practically he can seldom reach the reserve funds, even if there then be any;



because, among other reasons, he has no right to any means of finding out where they are. He cannot compel the attorney to assess his co-subscribers; for though the contract may give the attorney the right to levy assessments, it does not obligate him to do so. Consequently the policyholder's only recourse generally is against his co-subscribers directly. However, he cannot have recourse against all of them at once, because by his contract he must first prosecute to a finish a test suit against one before he can sue any of the others. Moreover, before he can sue them he must first find out their various names and addresses, together with evidence to prove that they were subscribers to the exchange at the time when his loss occurred or were otherwise parties to his policy; and, as has been seen, under the reciprocal law, the attorney is relieved from any obligation to furnish such information. Even if he be successful in obtaining such information and in securing judgment in his test suit, his troubles have only begun. Supposing that his total claim is for \$30,000 and that there are 300 co-subscribers, then each of the latter severally owes him on the average only \$100, subject, moreover, possibly to an offset which may or may not exceed that amount; and to recover the total amount due him he may have to collect all that is due from each and all of such co-subscribers. Some of them may have ceased to exist or be unable to pay. To get an effective judgment against each of the others who can but will not pay he may have to sue in many courts and in many States, so that the cost of the litigation may and probably will approximate if it does not exceed the amount of his claim. If any of the other subscribers so sued have anything due them on their policies they may, of course, offset the amounts thereof in such suits, so that many of such suits may prove to be veritable boomerangs. That such small and doubtful claims are seldom worth ten cents on the dollar is well known from common experience. That they may be worth practically nothing is indicated by the reported experience of the West Virginia firm cited at the beginning of this paper.

Where the insurance is for workmen's compensation the position of a reciprocal policyholder seeking to recover indemnity due from his co-subscribers would be even worse. Suppose that he has suffered an insured loss aggregating \$3,000, not presently payable, but obligating him to weekly payments for many years in the future—say for \$10 a week for 300 weeks. Then, if he has 300 co-subscribers, each of them on the average would become liable to him for 3  $\frac{1}{3}$  cents per week for 300 weeks. Of course the policyholder cannot collect such picayune sums as they fall due. On the other hand he cannot safely wait until the end of the 300 weeks so as then to sue for the aggregate liabilities, because the statute of limitations might supervene and many of his debtors might pass away in the meantime. Exactly what he could do under such conditions would vary according to circumstances; but certainly, even if his co-subscribers should have no offsets, he could never collect his \$3,000 net nor any material part of it. If, on the other hand, his co-subscribers generally should have offsets, as would probably be the case where the insurance is for workmen's compensation, a responsible policyholder with a large sum due him as indemnity would be in a



tangled maze of rights and liabilities from which he would be mighty lucky to extricate himself without still further loss. Therefore it is obvious that, if the exchange breaks down, a reciprocal compensation insurance policy is very apt to become either entirely or approximately worthless.

But even the foregoing low appraisal of the value of a reciprocal policy supposes that all the subscribers to the exchange had power to enter into contracts of reciprocal insurance and that all the contracts involved are valid. Such, however, may not be the case. Some of the subscribers may be corporations of States wherein it may be held to be *ultra vires* for a corporation to engage in the business of inter-insurance. And some of the subscriptions to the exchange may have been secured in States wherein the exchange had no authority to do business. Whether such subscribers could ultimately escape liability if fought through the courts to a finish may be doubtful. But that doubt and the expense of recovery against them yet further seriously reduce the probable value of a policy in a reciprocal exchange with a widely extended membership.

So far we have considered only the remedy of a reciprocal policyholder on his policy. But under the workmen's compensation laws the policyholder's injured workmen also are supposed to be secured by the policy. If then the policy may be practically almost worthless to the policyholder, of what value would it be as security to his workmen in the event of his insolvency? Theoretically it would be equally valueless. Practically it would be, if possible, still more valueless; for the average workman is peculiarly unable to pursue the long, multitudinous and expensive litigation that might be necessary to collect on it.

#### THE LIABILITY OF A SUBSCRIBER

As has been seen, the usual reciprocal contract so limits the liability of a subscriber and creates so many obstacles in the way of collecting from him, that, save in the event of some slip, his risk of liability seems to be trifling. But even if that be true it is as broad as it is long. For if the subscriber be practically immune from liability as an insurer, his rights and the rights of his employees as insured will be correspondingly precarious.

However, such immunity is far from certain. Two contingencies are to be feared: *First*. In those States wherein no special law is in force authorizing inter-insurance, subscribers to reciprocal exchanges incur the danger of being held liable as partners, in which event any conspicuously responsible subscriber might be selected as a target by many of the policyholders and forced to pay all of their claims in full. And the same might be the consequence if the reciprocal law of the subscriber's State should be declared unconstitutional, as was the first reciprocal law of Missouri. *Second*. The power-of-attorney the subscriber executes may not be framed in the most immunity bearing form, as assumed above. It may, on the contrary, only limit his liability to his co-subscribers to the amount of one annual premium on any one loss or on any one policy, in which event, if his premium be large and he have many co-subscribers, he may find himself liable in large amounts to many of



them—in the aggregate possibly for some hundred times his annual premium. Or it may even be that the power-of-attorney is so defectively drawn as to contain no effective limitation at all upon his liability, in which event he would be liable for just as much as if he were a partner, in spite of the reciprocal law. Consequently, whatsoever may be the probabilities, there is always some risk of ruinous liability in subscribing to a reciprocal exchange.

The foregoing relates only to the subscriber's liability to his co-subscribers. That, however, does not exhaust his risks of liability; for his power-of-attorney may involve him in very serious liabilities to his attorney-in-fact. As has been seen, the usual or, at least, a common power-of-attorney authorizes the attorney to deduct some fixed percentage of the subscriber's *gross* premiums for his remuneration and expenses, and then goes on to provide that either party may terminate the contract upon notice, upon which termination the subscriber's equitable *pro rata* part in the premium fund shall be *determined by the attorney* and returned to the subscriber. Such provisions are "baits to catch suckers." For example, the attorney may issue a three years' policy, collecting the first year's premium or deposit in cash, and the two later years' premiums in notes. He may then at once deduct his stipulated percentage of the total, which—if such percentage be 30%—would be 90% of the cash. If, then, a month later, either the attorney or the subscriber should terminate the contract, what would the former graciously determine to return to the latter as the latter's equitable *pro rata* part in the premium funds? Under such circumstances the subscriber would be lucky if he should get back his notes and lose only his first year's premium. But attorneys need not content themselves with such modest opportunities in this line of graft. By adding some innocent looking clauses to the power-of-attorney and an artfully drawn surrender-value table to the policy, the attorney-in-fact may put himself in a position wherein, if he can secure advance premium notes from his subscribers, he can not only keep all the cash but also enforce the notes and yet confiscate the insurance. According to Hon. John S. Patterson, quoted above, abuses such as just described are not only possible but also have been common in his part of the country.

#### EXEMPTION FROM TAXATION

Not content with exemption from supervision by the public authorities and from regulations to prevent impositions upon the public, promoters of reciprocal insurance often demand exemption from taxation. Other insurance carriers are taxed right and left, the aggregate taxes on the stock companies in some States mounting up to as much as 3% of their annual premiums. And in addition generally their agents also are taxed. In the face of this burden upon their competitors the reciprocals have the hardihood to ask that they be let off each with one small license fee. Naturally few States have granted any such sweeping exemption; but in many States substantial discriminations have been secured in their favor. Upon what ground can the claim for any such discrimination reasonably be based? Not upon the ground that reciprocal insurance is so superior to other forms of insurance that it is expedient for the State



to promote it by pecuniary favors; for, as has been seen, reciprocal insurance, as at present unregulated, has had a bad record and lends itself exceptionally to fraudulent practices. The argument of its promoters is that the premiums and funds of a reciprocal exchange should not be taxed because the subscribers are not in the business for profit. But the policyholders in stock companies are not in the business for profit, and yet their premiums are heavily taxed. On the other hand, if a stock company should be taxed because it owns the business and operates it for profit, so also should the attorney-in-fact of a reciprocal exchange, for he also owns the business and operates it for profit. The only distinction between them, in this respect, is that the stock company is financially responsible, assumes all risks and provides certain indemnity in return for a mere chance of profit, whereas the attorney-in-fact of a reciprocal is irresponsible and assumes no risk, but merely redistributes risks uncertainly among his subscribers, in return for large and certain profits. It is plain, therefore, that there should be no discrimination in the rate of taxation between them, or, if any, that it should be in favor of the stock companies.

#### CONCLUSION

As has been seen, reciprocal or inter-insurance is a novel form of insurance, radically different from Lloyds insurance. It resembles mutual insurance in that the subscribers bear all the risks; but it differs in that a third party owns, controls and manages the business, operates it for his own benefit, and derives profits from it. It resembles stock company insurance in that a third party owns, controls and manages the business of providing insurance for the policyholders; but it differs in that such third party does not assume the risks nor in any way become responsible for the payment of the indemnity. As a consequence it is subject to many of the dangers and abuses peculiar to each of those other forms of insurance, and yet it possesses the strength of no one of them. Therefore, so far from meriting exemption from all the regulations imposed upon any of those other forms of insurance, reciprocal insurance requires all the regulations common to all of them and many of the special regulations applicable to only one of them.

Nevertheless many reciprocal promoters demand practically complete exemption from all such regulations, and have secured it wherever the standard reciprocal law is in force. Where they cannot get that they seek to compromise. There is no right nor reason for any compromise. For even elementary protection to the public against prevalent frauds and abuses reciprocal insurance should be subjected to the following regulations at the least:

The powers-of-attorney and the policies of every reciprocal exchange should be subject to the approval of the Insurance Commissioner as to form.

The attorney-in-fact, before beginning business, should be required to furnish ample security for the proper performance of his duties; and thereafter he should be required to keep his funds and reserves deposited with some designated and responsible depository.



He should be required to maintain the same reserves as a stock company, under the supervision of the Insurance Commissioner.

He should be required to report annually to the Insurance Commissioner, not in the present deceptive form, but setting forth a proper balance sheet of his business, showing particularly the amount of his outstanding liabilities, calculated according to prescribed actuarial principles.

He should be required to keep proper books of account at his exchange, together with complete lists of his subscribers, accessible to his policyholders in case of need.

He should be forbidden to carry any single risk in excess of some reasonable proportion of his annual premiums, without approved reinsurance.

A real advisory committee should be provided for, to be elected by the subscribers, under provisions of law to assure a fair election, with full power of supervision and audit and with sufficient power of control to stop abuses.

The Insurance Commissioner should be given not only full power of examination and supervision but also authority to secure the appointment of a receiver to wind up a reciprocal exchange for the benefit of its policyholders, if he discovers that insolvency is certainly impending or that the attorney-in-fact is fraudulently misconducting the business.

The business of every reciprocal attorney-in-fact should be taxed at the same aggregate rate as the business of stock companies.

In favor of the foregoing proposed regulations it can be said that none of them would interfere with the normal conduct of the operations of a reciprocal exchange along honest lines and that none of them would discriminate against reciprocal insurance in competition with other forms of insurance, and yet that every one (with the reasonable exception of the provision as to taxation) would be to the positive advantage of reciprocal policyholders, by protecting them against some common evil or abuse. What then is the objection? The fact that there are honestly managed reciprocal associations and that some of them may also be so managed as to meet the requirements for security to their subscribers, is not a valid objection, since that objection would apply with yet greater force to regulating any other form of insurance. Therefore it is impossible to avoid the conclusion that the motive for the objection on the part of many of the promoters of reciprocal insurance is a desire to make use of the opportunities for fraud and illegitimate speculation which such exemptions secure them.

NEW YORK, JUNE, 1916.

P. TECUMSEH SHERMAN.







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